

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON, D. C. 20500

MARTIN FELDSTEIN, CHAIRMAN
WILLIAM A. NISKANEN
WILLIAM POOLE

June 19, 1984

MEMORANDUM FOR CABINET COUNCIL ON ECONOMIC AFFAIRS

Subject: Interest Rates, Stock Prices, and Monetary Policy

FROM: William Poole

Over the past few months the financial markets have been suffering from a case of the jitters. Interest rates, both short-term and long-term, have risen substantially since the turn of the year. Interest rate differentials between government securities and private securities have widened, suggesting a market search for lower risk. Stock prices have fluctuated around a flat to declining trend.

The first section of this memorandum contains a description of what has happened in the financial markets so far in 1984 against the background of longer-term trends in these markets. A discussion of the role of expectations--"market psychology"--and new information follows. As a footnote to this discussion a review of monetary policy before the 1980 election will be presented.

The concluding section contains some general comments on monetary policy and on the outlook for the securities markets over the second half of 1984.

Stock Prices and Interest Rates

Chart 1 provides a perspective on both the recent and long-term behavior of stock prices. The vertical lines in the chart mark off periods of recession. The fact that recessions are always accompanied by stock market declines, which usually begin well before the business cycle peaks, makes many observers uneasy about the recent market decline. However, there are numerous examples of market declines of a magnitude approximating the recent one, or larger, that were not associated with recessions. These declines are identified in the chart and their percentage magnitudes indicated.

In the absence of confirming evidence, a weak stock market should not be taken as a sign of probable recession; at this time almost all economic indicators show continuing economic growth. Thus, the best interpretation of today's stock market is that we have been witnessing a temporary reversal of perfectly normal magnitude within the context of a sound economic expansion.

-2-

As shown in Chart 2, both short-term and long-term interest rates have risen substantially since the turn of the year. The increase in short rates is somewhat, but only somewhat, larger than usually observed at this stage of the business cycle. The increase in bond yields is more troublesome.

At least as significant as the rise in yields, however, has been the behavior of interest rate differentials. During the expansion phase of the cycle it is normal for short rates to rise more than long rates, but between early January and early June 30-year bond yields rose by almost 200 basis points while 3-month bills rose about 100 basis points. (However, since early June the bond yield has dropped back about 50 basis points.) There has been a significant upward revision in the market's expected future level of interest rates. Table 1 (end of text), which reports changes in the Treasury bill and bond futures market rates, documents this observation.

Also noteworthy has been the behavior of yield differentials between government and private securities. As can be seen in Chart 3, CD yields have risen relative to Treasury bill yields. (Yields on CDs have also risen relative to those on commercial paper.) The recent increase in the CD yield spread over Treasury bills was caused primarily by the Continental Illinois Bank situation. This episode has had a much smaller effect on the CD spread than did the 1974 problems suffered by Franklin National Bank and Chase Manhattan Bank (in connection with the Chase Real Estate Investment Trust). The 1979-82 period of volatile monetary policy also led to rather large spreads.

Expectations and New Information

In exploring possible explanations for recent interest rate behavior--both changes in the general level of yields and in yield differentials-- it is necessary to give heavy weight to expectational issues.

The first thing to emphasize is that stock prices and long-term bond yields are determined by expectations over long horizons. The price of a stock does not depend on a firm's earnings this quarter or this year, but on the average earnings expected over a period of years. The interest rate on long-term bonds does not depend on current inflation or credit demands, but on expectations about economic conditions over a period of years. There is nothing necessarily peculiar about a stock price dropping when a firm reports higher earnings, perceived to be temporary, or about bond yields rising when current inflation is reported to be falling.

-3-

A second general point is that securities prices change on the basis of new information that alters expectations about the future. There is no reason for the price of a stock to change when good or bad earnings are reported if the report is about as had been anticipated. Nor is there any reason for long-term bond yields to change significantly if events unfold more or less as anticipated. To understand why interest rates rose so much between January and May we need to look for pieces of information on the economy that were "surprises", or unanticipated, as compared to the outlook in January.

The major unexpected developments over the past five months seem to be these:

- o The economy is considerably stronger than anticipated, with the 8.8 percent annual rate of increase in real GNP in the first quarter providing a broad measure of this strength. The growth of non-farm business output over the five quarters ending 1984:I is the highest for any five-quarter period since the Korean War with only two exceptions--the five-quarter periods ending 1959:II and 1973:I.
- o The strength of the economy has led to rising concern about inflation. This concern shows up frequently in market commentary. Survey information, reported in Table 2, indicates that inflation expectations stopped declining in the first half of 1983 and have increased slightly since.
- o Some Administration statements have been interpreted by the markets as attacks on the Federal Reserve that might lead to an inflationary policy.
- o There are new concerns in the markets that Congress will place additional pressure on the Federal Reserve that might also contribute to a more inflationary monetary policy.
- o Fears of banking instability have grown as a result of the Continental Bank situation. These fears are primarily responsible for the rising differentials between private and government securities yields.

Despite considerable market commentary, concerns about the Federal budget deficit have been left off this list. The reason is that the budget outlook has not changed very much since January, and so there has been no particular news in that area that could have driven interest rates higher. If

-4-

anything, the budget situation looks somewhat better now than it did in January because of the reduced FY 84 deficit estimates and progress in the down-payment negotiations.

Concerns about the budget deficit, however, interact with the other concerns in the list above. In particular, unexpectedly strong economic growth has raised fears that the predicted "clash" of government and private credit demands will arrive sooner than had been expected, providing less time to work out the budgetary problems. This analysis may or may not be correct but it no doubt lies behind some of the market concerns.

Pre-Election Jitters: The 1980 Experience

A number of observers have commented on the sharp increase in interest rates over the months leading up to the 1980 election. This episode deserves close examination.

Interest rates declined sharply in the first half of 1980. The 3-month bill rate (monthly average) fell from 12.07 percent in December 1979 to 7.00 percent in June 1980 as a result of the Carter credit controls and the short recession induced by those controls. After the middle of the year, when the credit controls were removed, the economy bounced back from the recession. With rising credit demands, continuing high inflation, and uncertainties over Carter Administration and Federal Reserve policies, interest rates rose; the bill rate reached 15.66 percent in December.

Money growth also rose significantly in the second half of 1980 as the Federal Reserve, apparently, attempted to dampen the increase in interest rates. Using data available at the time, the money stock (M1) grew at a 14.4 percent annual rate between May and November. There is reason to believe that this attempt to dampen rising interest rates backfired: when the Fed reported increases in the money stock, interest rates often jumped in anticipation of higher future inflation and the necessity of Fed action to raise interest rates to control obviously excessive money growth.

The effect of reported money growth on interest rates has been examined quite carefully in the economics literature. The basic findings can be sketched fairly briefly.

The Federal Reserve reports its weekly monetary data at 4:30 p.m. on Thursday afternoon (Friday afternoon in 1980). Each week the firm Money Market Services conducts a survey to determine what money market experts expect the 4:30 p.m. Fed report to show. The difference between the Fed's reported M1

-5-

and the market's expected M1 is a measure of the extent to which the reported M1 is a "surprise" (called an "innovation" in the statistics literature).

The next step in the analysis is to compare the M1 surprise to the change in interest rates between 3:30 p.m. just before the 4:30 p.m. data release and 3:30 p.m. the next business day. Although other developments may also affect interest rates over this 24-hour period, it is reasonable to assume that the money stock report is one of the most important pieces of economic news. Between the first weeks of June and November in 1980, the 24-hour increase in the Treasury bill rate following positive M1 surprises (reported M1 above expected M1) totaled 406 basis points; the total increase in the bill rate over this period was 577 basis points. The corresponding figures for 20-year bonds were 183 basis points out of a total of 194 basis points. Traders in the Government securities market confirm that they often see an immediate effect on interest rates when news of the Fed's M1 release appears on their monitors a moment after 4:30 p.m. on release day.

The effects of the 4:30 p.m. reports of monetary data on interest rates in 1980 are shown in Charts 4 and 5. These two scatter diagrams relate the M1 surprise (innovation) each week, plotted on the horizontal axis, to the interest rate change, plotted on the vertical axis. Chart 4 shows the change in the Treasury bill rate, and Chart 5 the change in the Treasury bond rate. Observations over the five months preceeding the 1980 general election are marked by boxes; other 1980 observations are marked by crosses.

Consider the observation marked by the box to the far right-hand side of both charts. The M1 surprise that week (data released August 12, 1980) was very large--the Fed reported a figure for M1 that was \$7.4 billion larger than the market was expecting. The three-month Treasury bill rate rose by 60 basis points (Chart 4), the bond rate by 19 basis points (Chart 5), and the one-year bill rate by 75 basis points (not charted).

From Charts 4 and 5 it is clear that the relationship between the money surprises and interest rate changes is far from exact; for one thing, analysis of the details of the 4:30 p.m. data release often indicates to the market that the significance of the M1 surprise is either greater or less than the aggregate M1 number might suggest. But the generally positive relation between M1 surprises and interest rate changes in these charts is unmistakable. Of the 23 money stock reports between June and November in 1980, 16 involved positive surprises--reported M1 greater than expected M1. It should be

-6-

emphasized that these were M1 surprises--predicted M1 growth was often positive but actual M1 growth was often even greater. Interest rates ratcheted up as these predominantly positive M1 surprises occurred in the months before the election.

As has so often been the case, in the months before the 1980 election the Federal Reserve was in an awkward position. Historically, the FOMC has attempted to follow policies that are politically neutral, at least in terms of popular conceptions about what "neutrality" means. If the Fed's policy is judged by interest rates, then tight policies were followed in the election years of 1972 and 1980 and an easy policy in 1976. But if policy is judged by money growth, then the Fed followed easy policies in 1972 and 1980 and a tight policy in 1976. For those years, interest rate watchers and money growth watchers have diametrically opposed views as to whether Fed policy was "easy" or "tight". (The money-watchers view was explored recently in the attached Wall Street Journal article by David Meiselman.)

More generally, it is surprisingly rare for monetary policy to be "easy" or "tight" as indicated by both money growth and interest rates; that is, it is relatively unusual for interest rates to fall with money growth rising or for interest rates to rise with money growth falling. (The months preceding the 1982 election were one of these exceptions.)

Given the nature of popular debates over monetary policy, it appears that the Fed sees "political neutrality" in this way: If credit demands are pushing interest rates up the Fed will allow rates to rise but will attempt to dampen the rise by permitting higher money growth; similarly the Fed will attempt to dampen falling interest rates by permitting money growth to slow. With this approach to policy some critics will be arguing that the Fed is following an easy policy for political purposes while others will be making exactly the opposite claim. The perception of Fed neutrality is preserved because Fed critics can't agree on whether monetary policy is tight or easy.

1984 Monetary Policy

From the 1980 experience, one of the most interesting questions for the remainder of 1984 is whether higher money growth is in fact likely to dampen upward pressure on interest rates. The market professionals, whose expectations and speculations have so much to do with short-run interest rate behavior, tend to have different views about monetary processes than do political figures, editorial writers, and "the man in the street". As explained above, the evidence is quite clear

-7-

that Fed reports of its money data move interest rates; that is a fact that should not be ignored.

But how can the effects of actual money growth be sorted out from those of reported money growth?

When interest rates are under upward (downward) pressure, an increase (decrease) in the actual money stock no doubt tends to dampen the interest rate change. But when the change in the money stock is reported--at present there is a ten-day reporting lag--the market reacts, as noted above. The net effect is unclear; in the short run, actual money growth dampens, but reported money growth exacerbates, interest rate pressures.

While the net effect of money growth on interest rates in the short-run is not clear theoretically, a little more can be said. The theoretical ambiguity applies especially to short-term interest rates--the rates on Treasury bills, CDs, commercial paper, etc. But for long-term interest rates, the announcement or reporting effect should dominate. The longer the maturity of a bond the more important will be expectational effects and the less important will be liquidity effects arising from changes in the rate of money growth. In my opinion, it is probable that attempts to dampen changes in long-term interest rates by accelerating or decelerating money growth will, net, be counterproductive as the markets react to the monetary data reported week by week.

Some analysts argue that the market's reaction to M1 surprises is entirely, or almost entirely, the result of the Fed's "monetarist" approach to policy. However, most monetarists contend vehemently that the Fed's policy is not now, and has never been, monetarist. Whatever the label attached to Fed policy, the contention that interest rates would not respond to the reported M1 data under a different type of Fed policy deserves serious attention.

In the short-run--day by day and week by week--Federal Reserve policy is presently implemented through operating procedures that have the effect of holding the federal funds rate within a fairly constrained range. Other interest rates, such as those on Treasury bills and bonds, are determined by market forces driven by credit demands and market speculation about Federal Reserve intentions. This market speculation depends on arriving information of many kinds, including especially the behavior of the monetary aggregates relative to the Federal Reserve's announced target ranges. The market assumes that the Fed will not let money growth go far off track. Suppose, instead, that the Fed simply made clear that it would not "tighten" or "ease"--raise or lower the federal

-8-

funds rate--in response to the behavior of the monetary aggregates. How would securities markets respond to reported money growth under such a policy?

Many non-monetarists argue that under such a policy the securities markets would not react to reported money growth. They point to instances in which the Fed has indicated that it would not respond to the M1 data, and M1 has in fact run far outside its target range without provoking speculative market responses pushing interest rates up or down. For example, in the fall of 1982, because of clear Federal Reserve statements, the market did not expect the Fed to react to rapid M1 growth. And, moreover, the market believed (correctly or incorrectly) that rapid money growth was appropriate and necessary for a variety of reasons. The most important of these reasons was the continuing recession, but the international debt crisis and the uncertainties over the monetary data due to changing bank regulations also played a role.

The behavior of the markets over the months immediately preceeding and following the November 1982 business cycle trough is consistent with the views of the non-monetarists. But the economic environment today is very different from that of late 1982. With the recovery firmly established, persistently high money growth is likely to lead fairly quickly to rising interest rates and falling bond prices no matter what the Fed does and says. As in the second half of 1980, the market will reason that unchecked high money growth will surely cause high inflation and, eventually, rising interest rates. The Fed might be able to hold down short rates for a while, but long rates will rise anyway because everyone knows that the Fed cannot hold short rates down for long by printing money. If, on the other hand, the Fed moves to check excessive money growth it will do so by pushing short rates up. Thus, after a period of several months of high money growth the market will come to believe that no matter what the Fed does interest rates will rise. The only way to prevent a speculative market response that bids interest rates up is to avoid the persistently high money growth that triggers the response.

Under conditions such as those prevailing this year the one exception to this general proposition about the relation between higher money growth and higher long-term interest rates involves the effects of a temporary bulge in the money stock when the banking markets are upset by rumors of possible bank failures. However, even in these circumstances it is important to understand that the Federal Reserve is able to offset extra bank reserves lent through the discount window to support particular banks by using open market operations to withdraw reserves from the banking system in general. Over the last few weeks the Fed has in fact not permitted liquidity support for weak banks to produce a ballooning of total bank reserves.

-9-

Outlook for the Second Half of 1984

The Administration's official projections for output and inflation cut down the middle of likely outcomes over the remainder of the year. These 1984 projections are quite close to the consensus of private forecasters. For 1985, however, the private consensus is for somewhat weaker real growth and somewhat higher inflation than the official Administration projection.

Interest rate projections are, as always, subject to a considerable range of uncertainty. I will offer four observations.

- o The market's best guess is that both short-term and long-term interest rates will rise.
- o The prevailing view in the financial press that bond yields can only rise is silly. It is simply preposterous to suppose that large numbers of professional portfolio managers are holding long-term bonds in the confident expectation of large capital losses from rising bond yields over the coming months. The magnitude of the possible losses from the predicted interest rate changes is far too large for the rising bond yield proposition to make any sense. For example, the increase in bond yields since January has cut the capital values of long-term bonds by about 12 percent. Long-term interest rates already reflect some probability that rates might rise further; but there is a roughly equal probability that rates will fall, in which case holders of long bonds will receive capital gains.
- o The importance of long-term expectations for interest rate determination cannot be overestimated. Investors will be and must be making guesses about the coming years. The greatest single concern in the bond market is the probable rate of inflation. Actions by the Administration, Congress, or Federal Reserve that seem to increase the odds of rising inflation will be greeted negatively, and vice versa.
- o Unexpected increases in money growth are very likely to produce increases in interest rates. It is arguable that under a different type of monetary policy the reactions of the credit market to reported changes in weekly money numbers would be substantially muted. But a major departure from

-10-

present monetary policy principles and procedures is improbable in the near future. At least through the November election the effect of announcements of monetary data on interest rates must be taken as a fact of life.

Table 1

Spot and Futures Interest Rate Comparisons

	<u>12/30/83</u>	<u>6/15/84</u>	<u>Change</u>
<u>Spot</u>			
3 month bills	9.27	10.22	.95
1 year bills	10.03	11.81	1.78
20 year bonds	11.98	13.18	1.20
 <u>Futures - bills</u>			
September 1984	9.82	10.73	.91
December	10.07	11.37	1.30
March 1985	10.31	11.81	1.50
June	10.52	12.13	1.61
September	10.71	12.37	1.66
December	10.88	12.54	1.66
 <u>Futures- Treasury bonds</u>			
June 1984	12.078	13.201	1.123
September	12.169	13.372	1.203
December	12.254	13.486	1.232
March 1985	12.335	13.581	1.246
June	12.405	13.663	1.258
September	12.470	13.732	1.262
December	12.529	13.795	1.266

Table 2

SUMMARY TABLE OF INFLATION EXPECTATIONS

SOURCES: 3 MO. & 1 YR. FORECASTS FROM ASA - NBER
 10 YR. FORECASTS FROM A.G. BECKER PARIBUS INC.

FORECAST DATE	3 MONTH INFLATION FORECAST	1 YEAR INFLATION FORECAST	10 YEAR INFLATION FORECAST (*)
12/75	5.8	5.9	
3/76	5.9	6.0	
6/76	5.5	5.7	
9/76	5.7	5.8	
12/76	5.7	5.5	
3/77	5.0	5.3	
6/77	5.8	6.0	
9/77	6.0	5.8	
12/77	5.3	5.6	
3/78	5.5	5.8	
6/78	6.3	6.4	
9/78	7.4	6.9	6.2
12/78	7.3	6.7	
3/79	7.7	7.1	
6/79	8.2	7.6	6.8
9/79	8.3	7.7	
12/79	8.1	7.9	
3/80	8.9	8.3	
6/80	9.6	8.5	8.6
9/80	9.4	8.6	8.8
12/80	10.1	9.0	8.3
3/81	9.6	8.7	
6/81	8.5	8.4	7.9
9/81	8.6	7.5	7.6
12/81	7.6	7.1	7.7
3/82	6.2	6.9	7.2
6/82	6.2	6.1	6.8
9/82	6.0	5.8	6.7
12/82	5.6	5.4	6.6
3/83	4.6	4.9	6.3
6/83	4.3	4.7	6.6
9/83	4.7	4.8	6.6
12/83	5.6	5.3	6.4
3/84	4.6	4.9	6.8
6/84			6.4

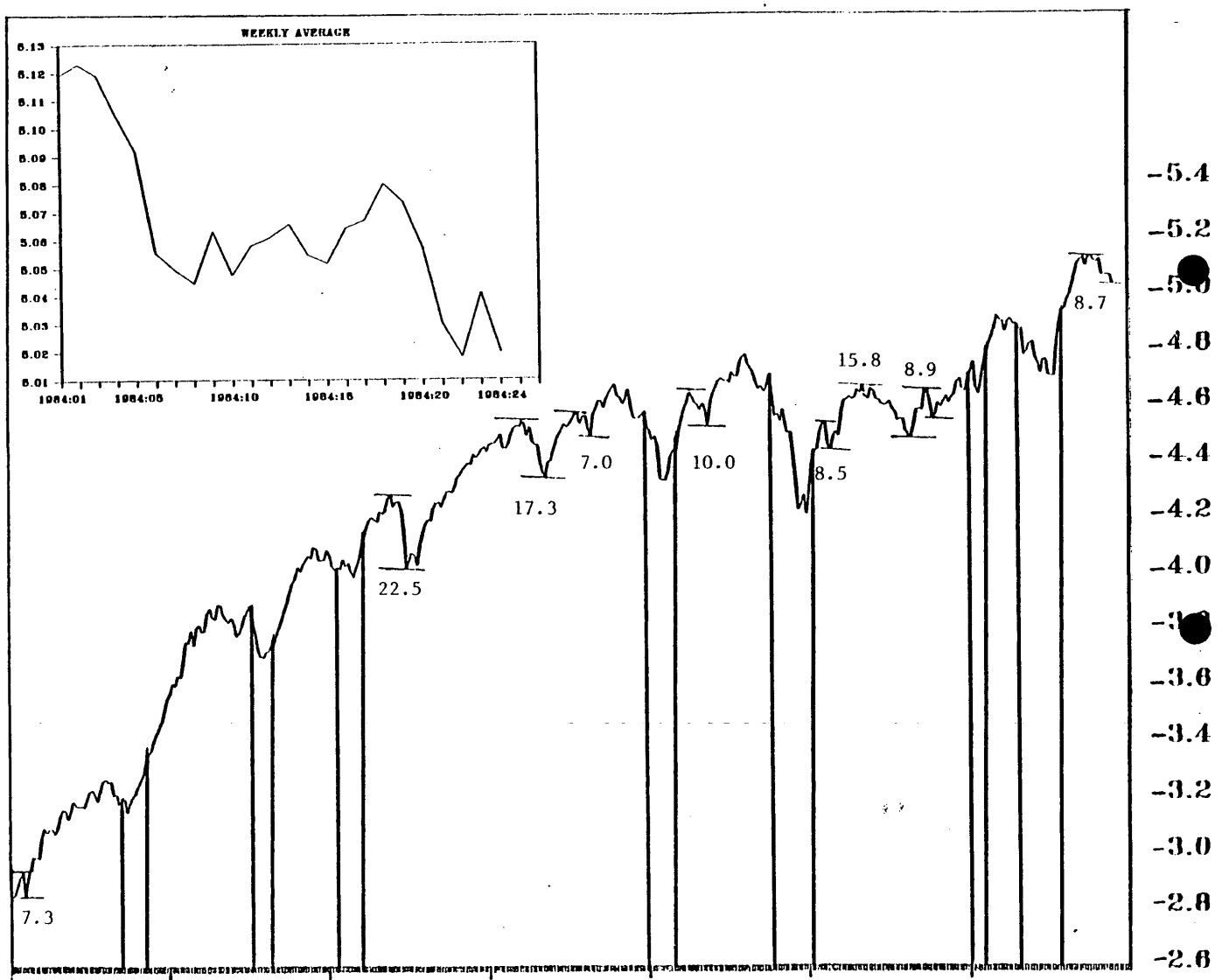
(*) Data for month closest to end of quarter

Chart 1

LOG OF STANDARD & POOR'S 500 INDEX

Approved For Release 2008/08/20 : CIA-RDP85-01156R000100150012-8

MONTHLY AVERAGE OF THE S&P 500



Approved For Release 2008/08/20 : CIA-RDP85-01156R000100150012-8

1980-1

TBILLS VS LONG GOVERNMENT BONDS YIELDS AND SPREAD

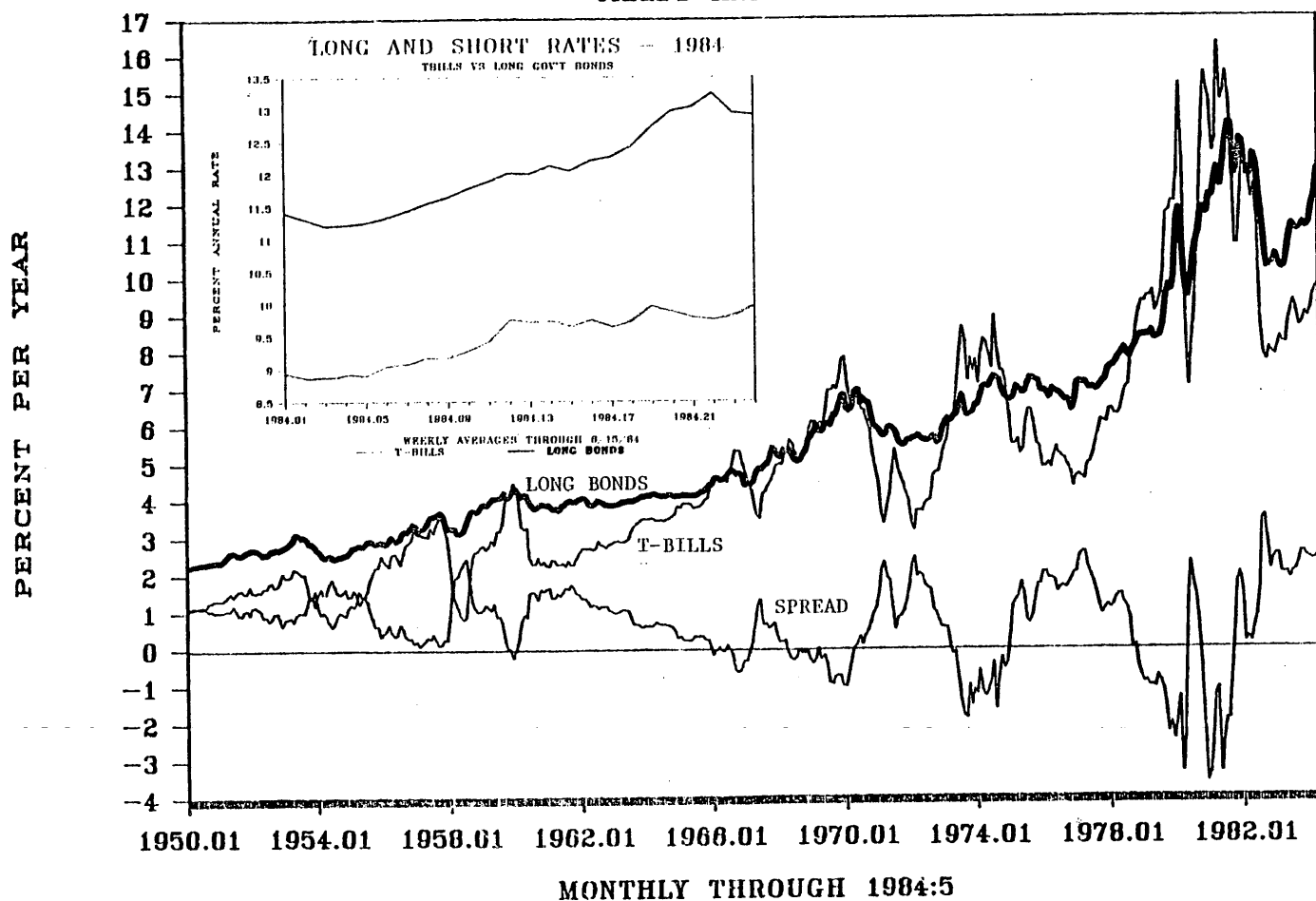
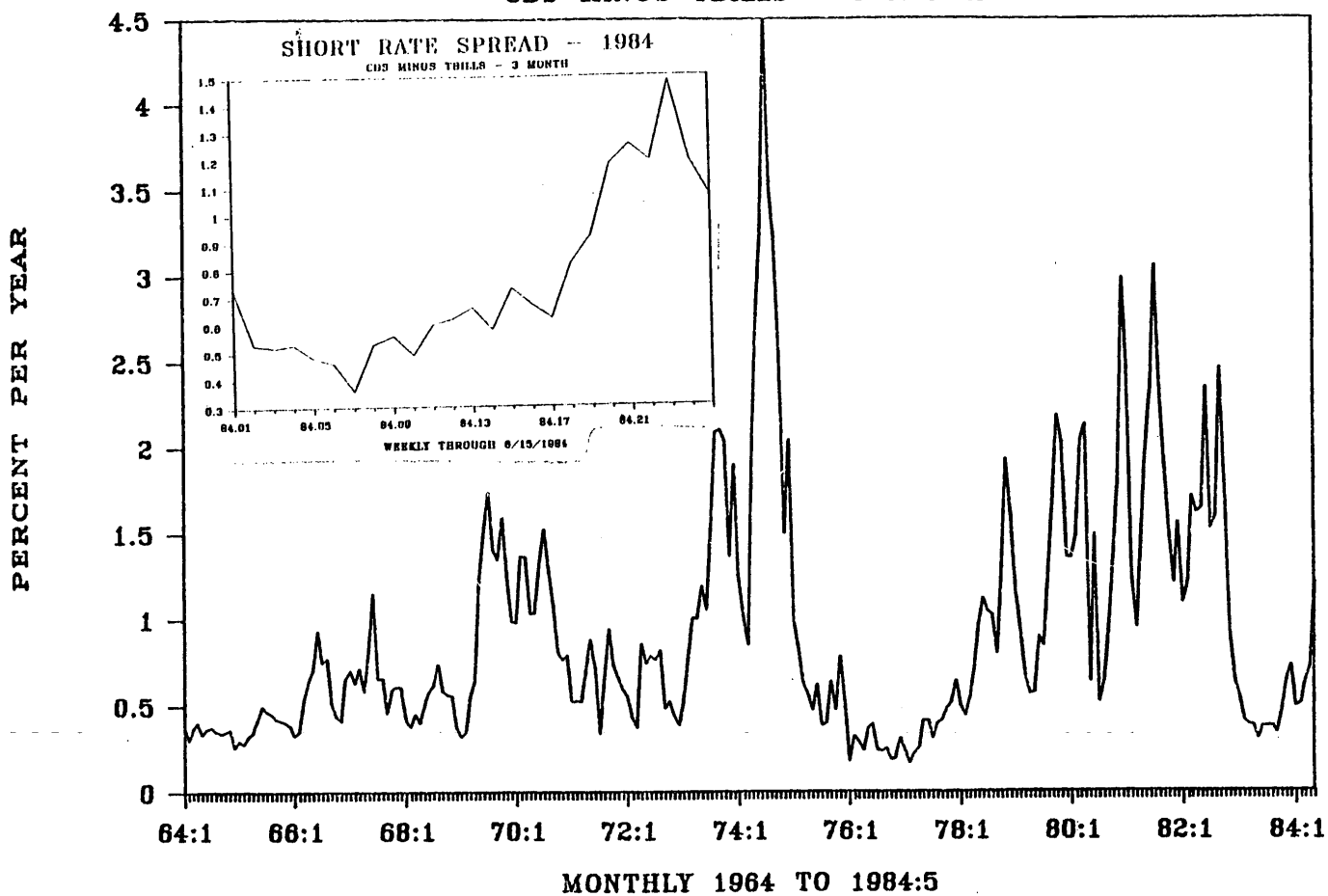


Chart 3

SHORT RATE SPREAD

CDS MINUS TBILLS - 3 MONTH



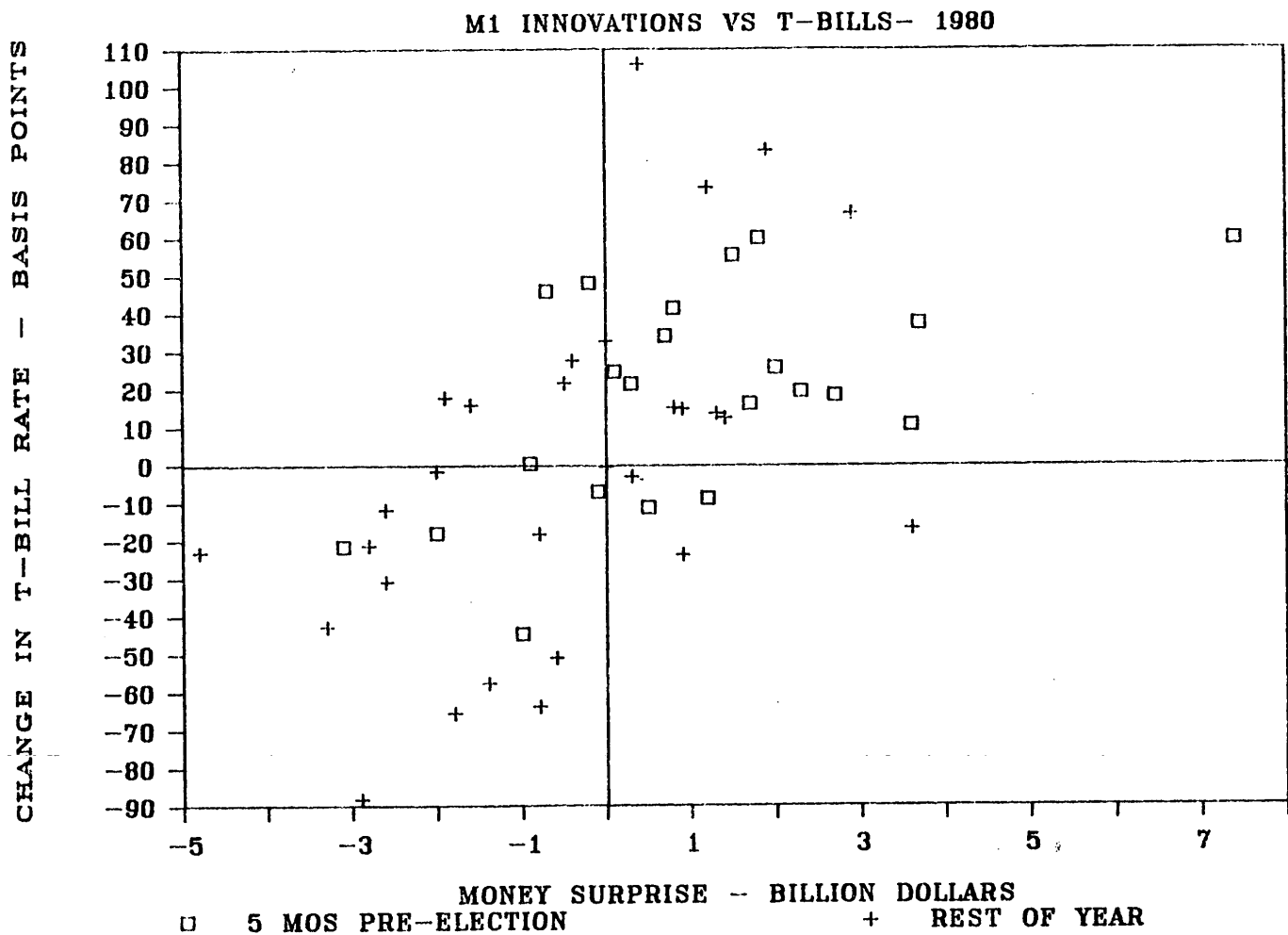
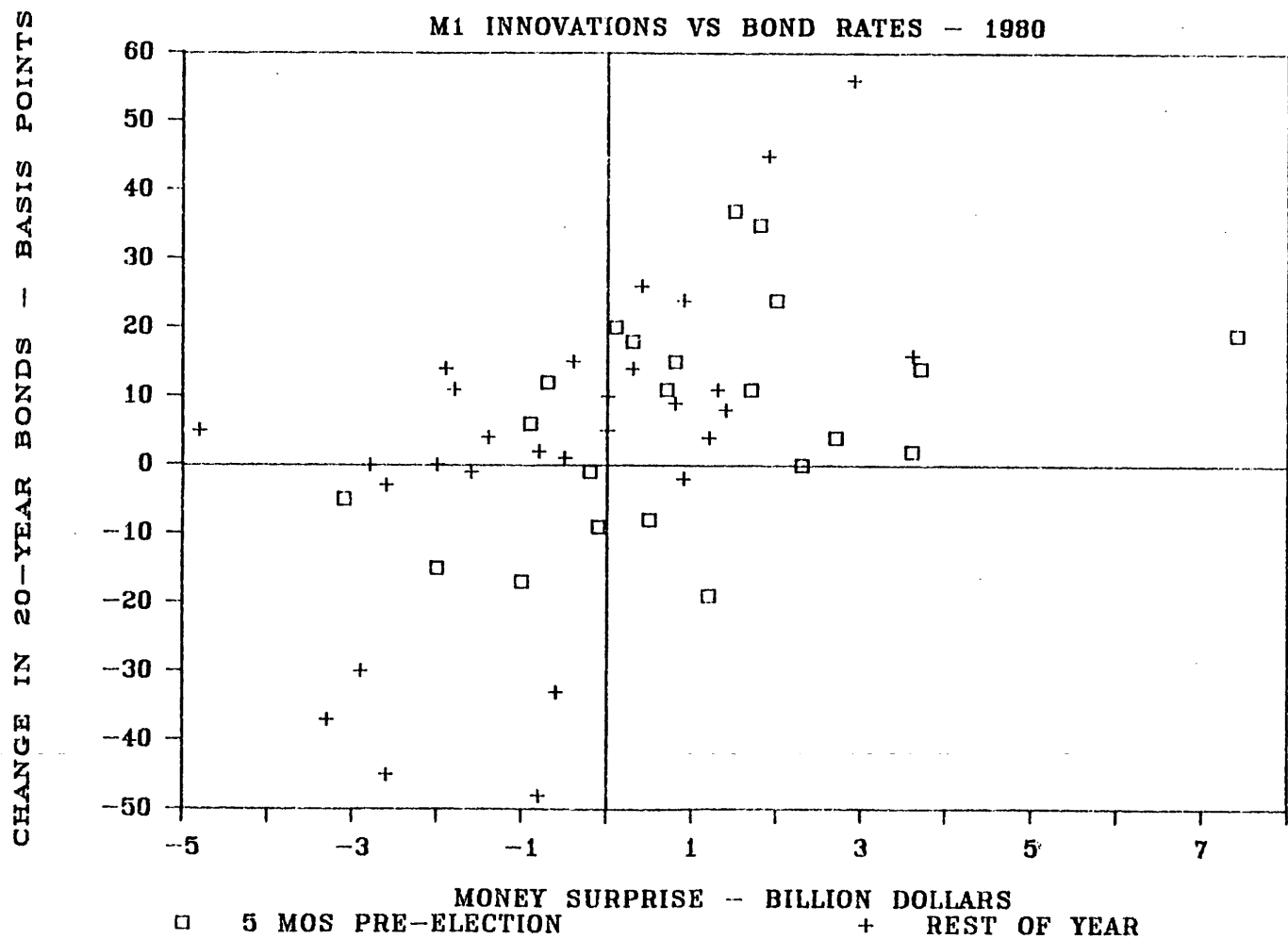


Chart 5



The Political Monetary Cycle

By DAVID I. MEISELMAN

Economic conditions influence voters on election day. Politicians can reasonably be expected to try to shape economic events to enhance their chances for election and reelection. More jobs, higher real incomes and lower inflation, especially in the months immediately preceding an election, are widely understood to benefit incumbents.

To help achieve these results, we see special favors to woe specific interest groups and pre-election payouts of Social Security and other transfer and subsidy money, with deferred postelection payments of taxes.

These are components of what is widely labeled the "political business cycle."

More scope for the use of fiscal action to affect election outcomes exists when, as has occurred, budgets and taxes increase and directly touch the lives of more voters. But what of the Federal Reserve and the conduct of monetary policy? To be sure, by statute the Fed is independent of the executive, including the White House and Treasury. Nevertheless, does the Fed pursue policies independent of election cycles and seasons?

The accompanying charts help to answer by showing what happened to money growth before and after each presidential election since 1960. They are derived from work originally done by Rob Smith of the Chase Manhattan Economics Department.

Recognition Lag

Money growth is calculated as the six-month rate of change of the M1 measure of money at annual percentage rates. The six-month lag is appropriate in a simple test. This is because of much accumulated evidence that changes in money growth affect real GNP with a lag of two to three quarters, particularly when there is a slack in the economy. (The most recent example of such a lag was the sharp and sustained step-up in money growth starting in July 1982 that led by year-end to the start of the current business revival.) The initial gains in output are temporary. They erode and finally disappear, replaced by higher prices.

To influence output in time to alter November voting decisions, money growth must speed up more than six months earlier. This is because the lags have some variability; because of the recognition lag in recording and then reporting the news, and because of the need to repeat good and then better economic news prior to November choices.

The economic and the political danger of fast money growth is inflation. Because faster money growth seems to have little impact on inflation for a year or so, with a peak inflation effect in about seven to eight quarters, there is little danger that faster money growth during an election year will

significantly affect inflation before the election itself.

The two different lags for output and for inflation are central to understanding how changes in the money stock shape economic events that influence election outcomes.

These lags mean that if the Fed were, in fact, to act in the interests of helping incumbents and their political parties, it would have powerful incentives to slow money growth 1½ to 2 years before presidential elections in order to slow inflation in the election season. This would also lower the level from which later money growth would have an enhanced impact on real income.

Later, the Fed would increase money growth during election years to speed eco-

my through time; this reflects the long-period upward drift of money growth from 2% at the time John F. Kennedy was elected to 15% at the time Mr. Carter was defeated, which parallels the long-period upward drift of inflation from 1.5% in 1960 to 13.5% in 1980.

There are three phases in the political-monetary cycle. In the first two phases, no clear differences emerge in the patterns of money growth whether Republicans or Democrats occupy the White House.

Phase I starts about a year and a half before the election, somewhat later than required for optimal anti-inflation effects. It continues for the next two to three quarters. In this phase, there is a marked slowdown of money growth in every election cycle. The Fed's recent sharp deceleration

money growth was after the election of Mr. Carter. From a low of 5.1% in November 1976, M1 growth soon almost doubled and reached 9.6% in March 1977, foretelling the return to double-digit inflation two years later. This suggests, as it is said of the Supreme Court, that the Federal Reserve also reads the newspapers. President Carter's team was talking stimulation from the early going.

Only in Phase III of the political monetary cycle is there a marked difference in Fed behavior under Republican and Democratic presidents. Under Democratic Presidents Kennedy and Johnson, the post-election slowdown of money growth was quickly abandoned. A year after the 1960 and 1964 elections, money growth was faster than at the election peaks.

Under Republican presidents, the post-election slowdown in money is severe enough and persists long enough to lead to an economic recession starting the first year of both Nixon terms and the Reagan presidency. Stock prices also tend to fare worse in first years of Republican presidents. Indeed, when Republicans have occupied the White House, there has been a recession during the year of every off-year congressional election since 1930, with resulting losses of Republican congressional seats.

Economic Distress

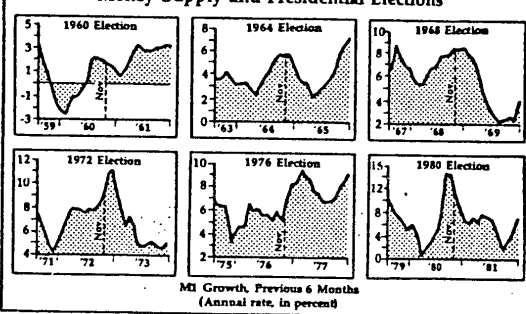
These exquisitely timed cycles cast serious doubts on the policy independence of the Federal Reserve. I have no way of knowing what was on the minds of Fed officials or what they hoped to achieve. But whatever the motivations and goals of the Federal Reserve during these systematic and recurring stop-go cycles, the monetary cycles themselves, and the resulting economic and financial gyrations that have been major factors in the growth instability of the U.S. economy, would not have been possible under the constraints of a monetary rule mandating slow, stable and predictable money growth whatever the political season or the political party in power. For fiscal policy, the appropriate constraint would be an effective balanced budget-tax limitation constitutional amendment such as the one that passed the Senate last year and failed in the House.

More immediately, unless the long period of slow and then no M1 growth imposed by the Fed since June is soon ended, we face the prospect of an economic slowdown in 1984. The resulting economic distress will be matched, even earned, by the distress of the Republican Party after the votes are counted in November 1984.

After all, who reappointed Paul Volcker?

Mr. Meiselman is professor of economics and director of the Graduate Economics Program in Northern Virginia, Virginia Polytechnic Institute and State University.

Money Supply and Presidential Elections



mic growth. This way, incumbents might benefit both from reduced inflation as well as the initial good news of higher output and employment, plus the traditionally rising stock prices of presidential election years. Incumbents would also be able to defer the costs of the inevitable bad news of more inflation until after the votes are cast.

A major risk in the early phase of this strategy is overdoing a "good" thing. As elsewhere, fine tuning can backfire, and stepping on the monetary brakes too hard and too long may cause a recession—to the detriment of the incumbent and the incumbent's political party. The sharp contractions of money growth starting in July 1959 and August 1979 were preludes to the recessions that started in election years 1960 and 1980 and played major roles in the defeats of Richard Nixon and Jimmy Carter. Pre-election surges in money growth starting in March 1960 and in June 1980 could not undo the harm.

As the charts show, money growth in five of the six past presidential election cycles since 1960 follows the same general pattern. Note how the vertical axes shift

of M1 growth since mid-1983, from 14.5% at midyear to 3.9% for the six-month period ending in mid-December, is consistent with the direction of earlier experience. It differs in the severity of the decline, which is matched only by the collapse of money growth in 1979 and early 1980.

In Phase II, which generally starts two to three quarters before the presidential election, money growth changes direction and speeds up, with a peak in November or within two months of it.

The only exception to ever-faster money growth in the periods before elections was in 1976. Following the usual slowing of money growth starting in mid-1975, money growth picked up in early 1976. However, it reached a peak in April 1976 and then generally drifted down for several months until November. Gerald Ford lost the election.

The final phase of the political monetary cycle starts after elections. The Fed changes direction again and steps on the monetary brakes. Typically, stock prices do poorly in the first year of a presidential term.

An exception to postelection slower



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MEMORANDUM TO THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: J. Gregory Ballentine *JGB*

SUBJECT: Money and Inflation

I. The Unreliability of Short-Term Money Data

- o Only relatively long-term (e.g., at least quarterly) changes in M1 growth provide a reliable guide to the tightness or looseness of monetary policy.
- o Weekly, or even monthly, data on changes in M1 growth can be very misleading.
 - Weekly and monthly data are subject to large revisions.
 - Even revised weekly and monthly M1 growth rates are extremely volatile. (In relatively stable money growth years, for example, it is not uncommon for monthly M1 growth to range from 0% to 12%.)
 - Weekly and monthly fluctuations in M1 growth that are temporary do not have significant effects on the economy.

II. Revisions to Short and Longer-term Growth Rates

- o Shown below are initially reported M1 growth rates and revised growth rates for weekly, monthly, quarterly, semi-annual, and annual growth rates.

Weekly (4-week annualized growth rates)			
<u>May 1983</u>	<u>Old</u>	<u>Revised</u>	<u>Difference</u>
May 2	0.3	11.0	10.7
May 9	32.3	19.3	-13.0
May 16	47.5	30.6	-16.9
May 23	41.5	28.9	-12.6
May 30	26.1	23.2	-2.9
Average Revision: 11.2			

Monthly (Annualized)			
<u>1983</u>	<u>Old</u>	<u>Revised</u>	<u>Difference</u>
Jan.	10.2	12.1	1.9
Feb.	24.9	15.9	-9.0
Mar.	17.1	13.7	-3.4
Apr.	-2.6	3.7	6.3
May	29.8	23.1	-6.7
June	10.7	10.7	0.0
July	9.3	9.8	0.5
Aug.	2.8	6.0	3.2
Sep.	0.9	3.5	2.6
Oct.	1.9	6.4	4.5
Nov.	0.9	3.3	2.4
Dec.	6.7	5.4	-1.3
Average Revision: 3.5			

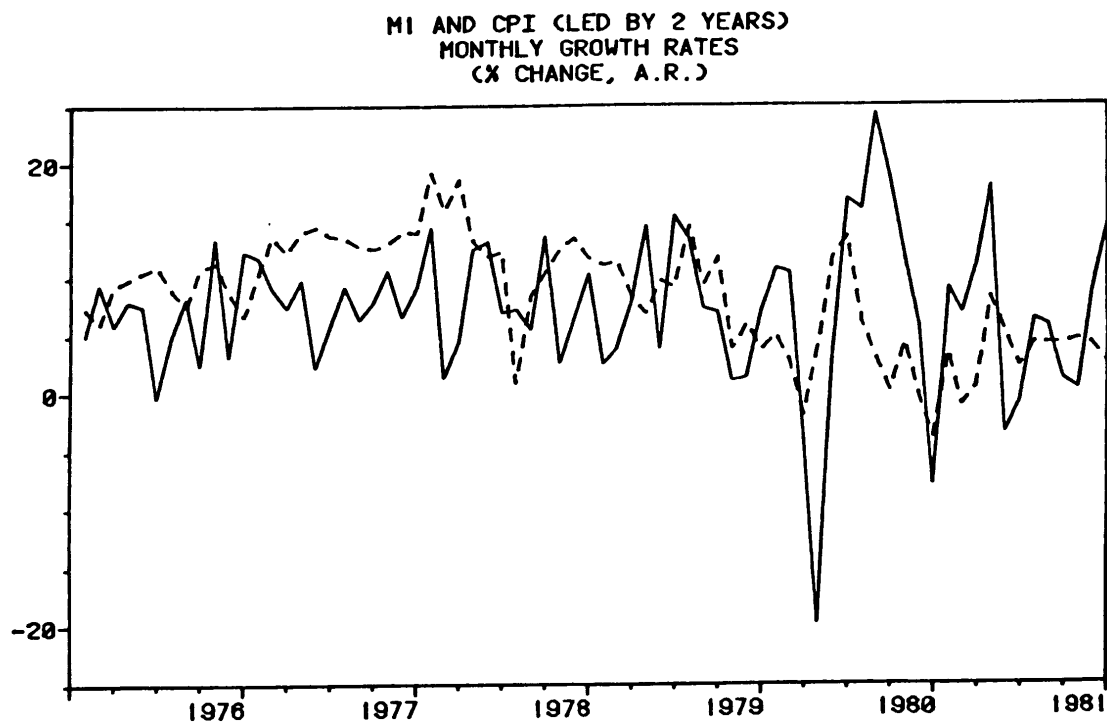
Quarterly (Annualized)			
<u>1983</u>	<u>Old</u>	<u>Revised</u>	<u>Difference</u>
Q1	14.9	13.4	-1.5
Q2	12.8	12.1	-0.7
Q3	9.2	9.8	0.6
Q4	2.1	4.9	2.8
Average Revision: 1.4			

Two Quarter Growth Rates			
	<u>Old</u>	<u>Revised</u>	<u>Difference</u>
Q4/82 to Q2/83	14.0	13.0	-1.0
Q2/83 to Q4/83	5.6	7.3	1.7
Average Revision: 1.3			

Four Quarter Growth Rates			
	<u>Old</u>	<u>Revised</u>	<u>Difference</u>
Q4/82 to Q4/83	9.6	10.0	0.4

III. Short-term Growth Rates and Inflation

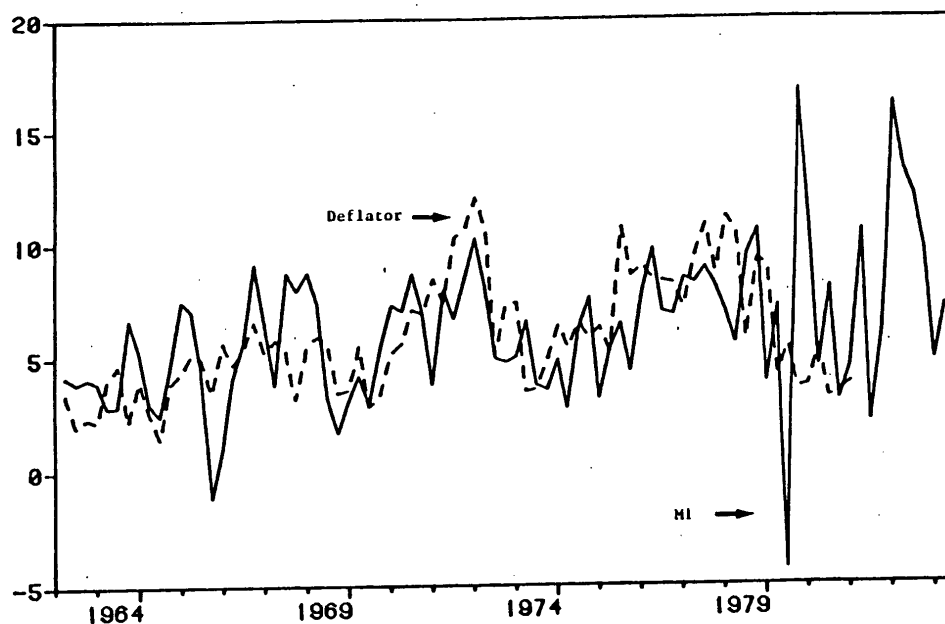
- o Even revised data on short-term M1 growth rates have little economic meaning and, in particular, are poorly correlated with inflation.



- o The monthly fluctuations in M1 growth shown above explain only about 1% of the monthly fluctuations in inflation (based on a simple linear regression over the time period of the chart.)

- o Quarterly growth rates are less volatile, but still they are not well correlated with inflation.

M1 AND GNP DEFLATOR (LED BY 2 YEARS)
QUARTERLY GROWTH RATES
(% CHANGE, A.R.)

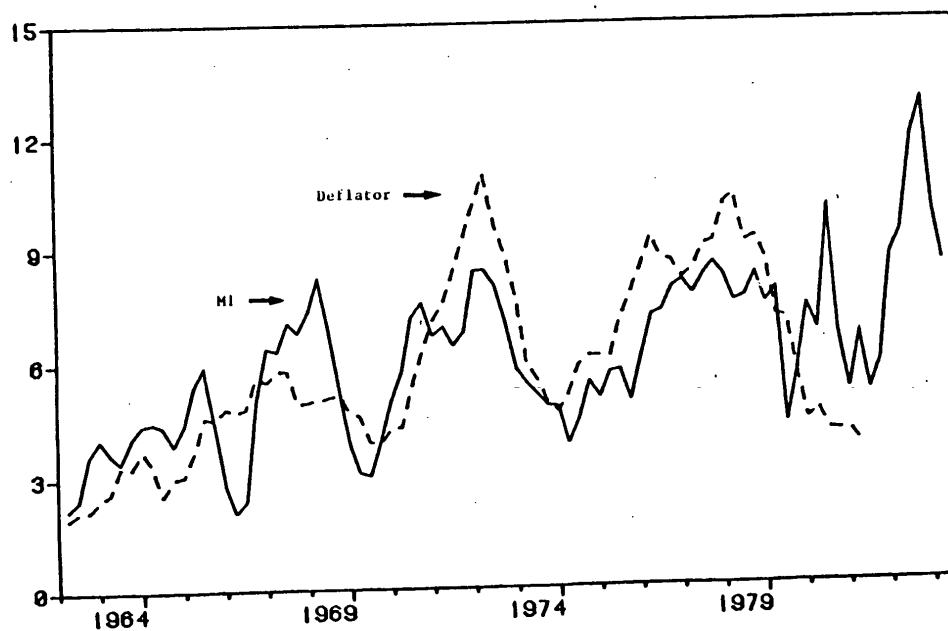


- o The quarterly fluctuations in M1 growth shown above explain only about 10% of the quarterly fluctuations in inflation (based on a simple linear regression over the time period of the chart).

IV. Longer-Term Money Growth Rates and Inflation

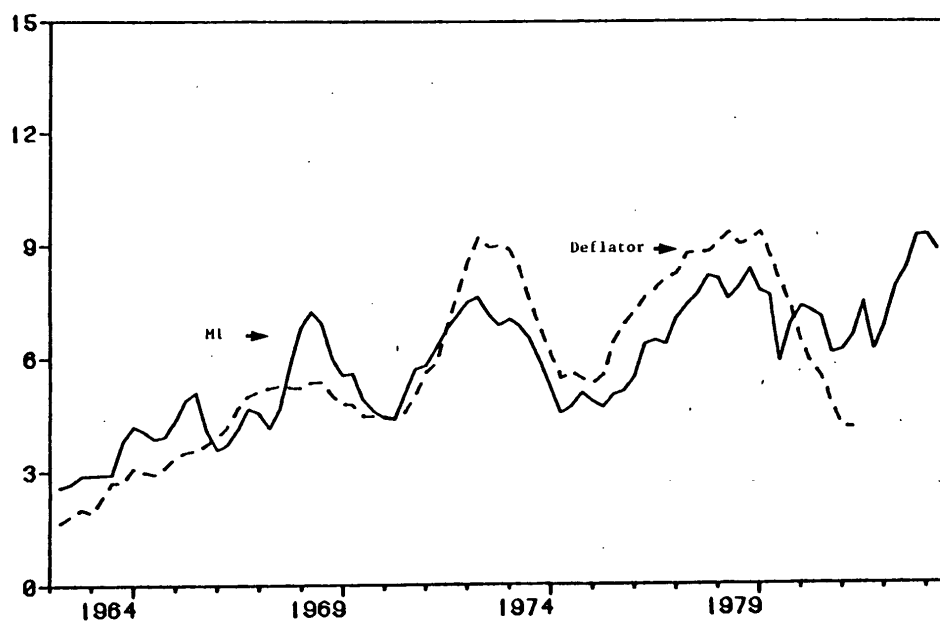
- o Sustained changes in M1 growth (i.e., changes that influence longer-term measures of growth) are correlated with nominal income growth and inflation.
- o The more long-term the growth rates used, the closer the relationship between M1 and inflation.
- o Four-quarter M1 growth rates "explain" about 45% of 4-quarter inflation rates.

M1 AND GNP DEFLATOR (LED BY 2 YEARS)
FOUR QUARTER GROWTH RATES
(% CHANGE, A.R.)



- o Eight-quarter M1 growth rates "explain" about 75% of 8-quarter inflation rates.

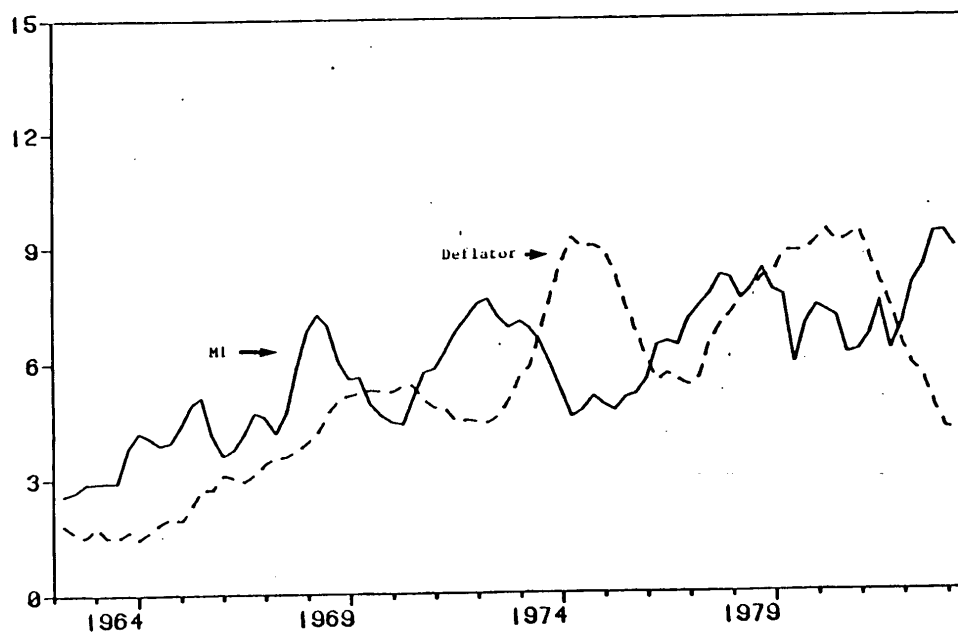
M1 AND GNP DEFLATOR (LED BY 2 YEARS)
EIGHT QUARTER GROWTH RATES
(% CHANGE, A.R.)



V. The Lag Between M1 Growth and Inflation

- o The relationships presented show a two-year lag between growth in M1 and inflation.
- o There is no relationship between current M1 growth and current inflation.

CURRENT M1 AND CURRENT GNP DEFLATOR
EIGHT QUARTER GROWTH RATES
(% CHANGE, A.R.)

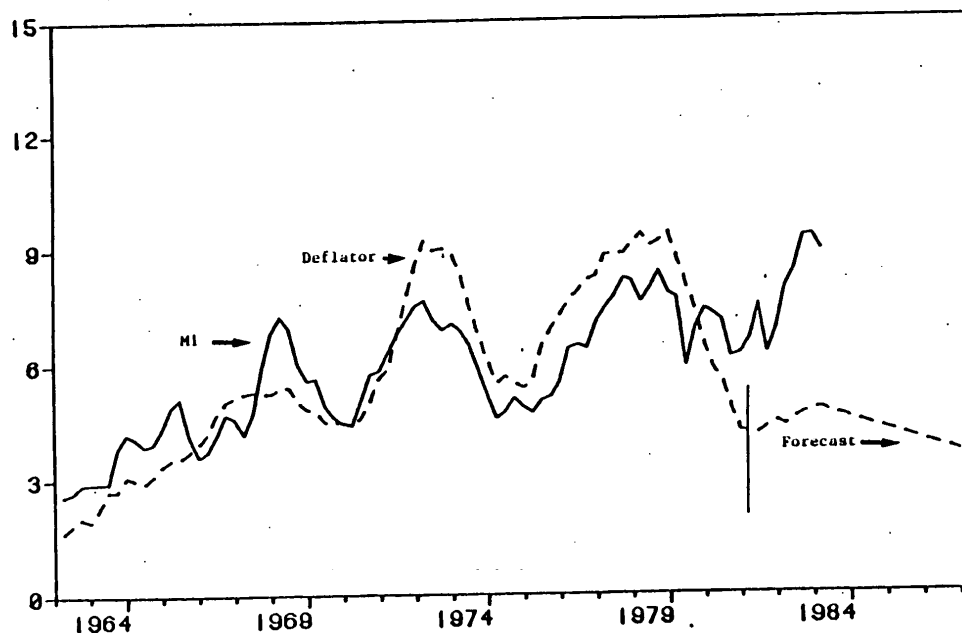


- o A policy that maintains rapid money growth until current inflation rises risks a dramatic rise in inflation.

VI. Implications for Future Inflation

- o Our forecast assumes that inflation will rise very slightly then decline through 1989.

M1 AND GNP DEFLATOR (LED BY 2 YEARS)
EIGHT QUARTER GROWTH RATES
(% CHANGE, A.R.)



- o For this forecast to be realized, either:
 - money growth must slow dramatically, or
 - the relationship between inflation and long-term money growth, which has been an accurate predictor of inflation in the past, must no longer hold.